Sole proprietorship as a business structure for startups

For anyone wishing to start a business of their own the primary issue of the greatest importance is the legal skeleton they wish to chose upon which they wish to prop up their business. Broadly there are 4 types of legal structures that can be chosen when one wishes to start their business - Self proprietorships, partnerships, Limited Liability Partnerships (**LLPs**) or companies.

Each of these structures has many variations which come with their own benefits and drawbacks. Which form is chosen by an individual business ultimately depends on the characteristics and needs of the business. This chapter will explain situations where a sole proprietorship business may be useful and also compare it with the newly launched one-person company under the Companies Act 2013.

What is a sole proprietorship?

Sole Proprietorship is a business enterprise that is owned and controlled by one person who possesses the entire authority & responsibility with respect to the business. He can hire employees and pay them salaries, but legal responsibility for the obligations of the business is on the sole proprietor. The practical implication of such an arrangement is that an owner alone gets the entire profit (after paying costs) but he is also personally liable. This is so as a proprietorship is not a distinct entity unto itself, rather the business and its owner are clubbed together. For example, no separate tax returns are required to be filed by the business and the proprietor must disclose the income from his business in his personal income tax return itself. This form of business is ideally suited to businesses where the nature of the business is simple, financial risk is minimal, there is no need to take huge debts and the product's market is small. Business with small capital requirements and low levels of risk are apt for being run as sole proprietorships. Many '*kirana'* shops or mom-and-pop stores, small home-based ventures and often startups with a sole founder (at least in their initial stages) are structured as sole proprietorships.

What are the advantages of a sole proprietorship?

A defining feature of sole proprietorships is the ease and informality with which it can be created and dissolved.

- ***Cost effective:*** Since no formal registration is needed there is no cost at all in setting up a sole proprietorship. However, operating the business from a separate space will require you to obtain business specific registrations such as a trade Shops and Establishment Registration and in some states, a trade licence (see subsequent chapters of this course for a detailed discussion on trade licence). Additional income tax registrations (apart from a simple PAN card) and service tax registrations may be required if the business crosses a certain turnover threshold.
- ***Flexible business decisions:*** Since one person owns the business and has absolute control he can always make quick decisions and be flexible as well (since even fundamental changes to the business are subject only to his will).
- ***Control over financials of the company:*** Retention of complete control over the finances of the business all of whose profits flow to the owner means that this form of business organization gives a very strong incentive for work to the business owner.
- ***Business relations:*** Often the sole proprietorship business model is found in lines of work where close personal relations are maintained since the sole proprietor is capable of ensuring adequate one on one relation with both employees and customers.
- ***Confidentiality:*** Ensuring the safety of business secrets is also a much easier task in this form of business organization than any other.

What are the disadvantages of a sole proprietorship?

The problems with the sole proprietorship model of business are fourfold.

- ***No perpetual succession:*** It can exist only for as long as the owner exists (an end can be put to the business by the owner's death or insolvency).
- ***Difficult to hire and retain employees:*** Expansion of the business beyond a certain point becomes very tough as since the proprietor cannot be an expert in every aspect of business management more employees are needed. However, good quality employees (whose long term aim is often sharing the benefits of ownership) are difficult to attract owing to the individual centric model that characterizes sole proprietorship.
- ***Raising capital:*** As sole proprietorship is run by a single person, it is difficult to raise capital. Lack of separation of the business from the proprietor hinders the flow of capital

and thus expansion of the size of the business notwithstanding the extent of the success of the business or its product. Loans from friends and family is usually the most practical way to access finance. Banks have started providing SME loans, which may also be useful.

- ***Unlimited liability:*** Sole proprietors have unlimited liability, which means that in a situation where a sole proprietor fails to meet his debts or business obligations and a lawsuit is filed by a consumer then the personal properties of the proprietor could also be disposed of to satisfy the debts. This may be a risky structure where a business has a very high turnover and transaction size, as the financial risk involved is higher – in such situations, a Limited Liability Partnership (**LLP**), a one-person company or a private limited company will be preferable (see subsequent chapters which explain the comparison between those vehicles).

What are the legal compliances to be met for running a sole proprietorship business?

One of the positive features of a sole proprietorship is that there are only a few legal formalities that need to be complied with to start it. While no formal registration is needed to start a sole proprietorship there are other taxation and business related formalities that need to be complied with.

- ***Bank account:*** One should open a bank account in the name of the proprietorship firm.

  Business licenses: The business can be run out of home but if the proprietor wishes to run it out of a commercial place then the provisions of the Shop & Establishments Act need to be complied with, the provisions of the Act themselves vary across states. Generally there are provisions requiring an establishment's owner to get his establishment registered along with a fee that may be specified (information such as the manager's name, the establishment address and name and its category may need to be provided). Opening and closing hours are specified in addition to norms relating to work and other miscellaneous activities.
- ***Tax registration:*** It is mandatory for the proprietor to possess a PAN card (since all the returns are filed in the proprietor's name). Businesses with a turnover exceeding Rs 9 lakh need to pay a 10% service tax and hence need to be registered. If the business of the

proprietor involves the procurement and sale of taxable goods in the state then registration for VAT (Value Added Tax) is needed. If the buying or sale of taxable goods is across different states then registration for CST (Central Sales Tax) is needed.

- ***Importer-Exporter Code:*** If the proprietor wishes to engage in international trade he needs to obtain an Importer & Exporter Code from the Director General of Foreign Trade.

- ***Business Licence and Labour law compliances:*** A Professional Tax has to be paid to the government if the proprietor has employees (on a per employee basis). Shops and Establishment Act registration is required if the business operates from a shop or office. The levy of this tax varies across states, with some not having it and others collecting it annually. The Employee State Insurance Act, 1948 requires registration under it if 10 people are employed in a factory and 20 people in establishments other than a factory.

- ***Trademark registration:*** It's generally a good idea to come up with a trade name for the business and get it trademarked.

You will be taught more about the detailed compliances under labour laws, business licenses, importer-exporter code and trademark registration later within the course.

Is it necessary to register a proprietorship firm or execute a registered document?

There is no requirement under any law to have a separate registration or execute a registered document. However, for the sake of clarity and give assurance to the creditors, often the proprietors execute a "Proprietorship Declaration" document and get it registered with the Registrar or sub-registrar appointed under Registration Act, 1908.

What are the differences between a sole proprietorship and a one person company?

Differences between one person company (OPC) and sole proprietorship

Features	One Person Company (OPC)	Sole Proprietorship
Registration	One person company needs to be registered under the new Companies Act, 2013.	Sole proprietorship does not require separate registration.
Meetings	Exempted from conducting general meetings and board meetings.	There is no need to conduct general meetings and board meetings.
Legal entity status	Separate legal entity - One person company and the shareholder are considered different.	It is not a separate legal entity, the proprietor and the entity are one and the same.
Liability	**The sole shareholder has limited liability.**	Liability of the proprietor extends to his personal assets.
Time	Initial set up of an OPC is more time consuming.	Initial set up is less time consuming in registration and procedural requirements.
Expense	More expensive, since one may need to hire a lawyer or company secretary for compliances.	Less expensive as compared to OPC as there is only a few legal compliances that must be met.
Perpetual Succession	OPC has perpetual succession with death of the shareholder not impacting the existence of the company.	No perpetual succession with death of the proprietor can lead to dissolution of the proprietorship.
Audit	OPCs must submit financial statements and need to conduct audits.	Audits would need to be carried out only as per the Income Tax Act on the turnover exceeding the threshold.
Tax	One person company is taxed separately from the owners. An OPC would be charged at	Proprietorship is not taxed independently, but with the proprietor's income. This reduces the effective rate of

	the 30% base tax rate on profits, minimum alternative tax (18.5%) and dividend distribution tax (15%) as well.	taxation as the rate of 30 percent is applicable only when income of the proprietor crosses INR 10 lakhs. There is also no tax on distribution of profits.
Loan	Repayment of loans is the responsibility of the OPC, not the sole shareholder.	Any loan taken by the proprietor is their sole responsibility.
Finance	Finance is based on the credit record of the OPC.	Finance is based on the credit record of the proprietor.